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No. 95-1347

In The

Supreme Court of the United States

October Term, 1995

THE PRICE COMPANY, ROBERT E. PRICE, DENNIS R. ZOOK and THEODORE WALLACE,

Petitioners,

v.

MAX FECHT, NORMAN COOPER, HAMILTON J. SAH, ELAINE ALGEO and JOSEPH LASENSKY, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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10 pp

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

I. The Important Question Presented by This Petition Has Not Been Decided with Respect to Hundreds of Cases Pending in the Federal Courts, and This Court Should Adopt a Uniform and Rigorous Rule 9(b) Standard for These Cases 1

II. This Court Should Grant the Writ and Expressly Reject Respondents' Position that Allegations of Isolated Employee Stock Sales Are Sufficient to Raise an Inference of Fraudulent Intent Under Rule 9(b) 2

CONCLUSION 7

TABLE OF AUTHORITIES

Page

Cases

Apple Computer Sec. Litig., In re, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990) 6

Arazie v. Mullane, 2 F.3d 1456 (7th Cir. 1993) 4

Cohen v. Koenig, 25 F.3d 1168 (2d Cir. 1994) 6

Cosmas v. Hassett, 886 F.2d 8 (2d Cir. 1989) 6

Denny v. Barber, 576 F.2d 465 (2d Cir. 1978) 3

DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990), *cert. denied*, 498 U.S. 941 (1990) 1, 4

GlenFed Sec. Litig., In re, 42 F.3d 1541 (9th Cir. 1994) (*en banc*) 1

Goldman v. Belden, 754 F.2d 1059 (2d Cir. 1985) 6

Greenstone v. Cambex Corp., 975 F.2d 22 (1st Cir. 1992) 1, 4

O'Brien v. National Property Analysts Partners, 936 F.2d 674 (2d Cir. 1991) 1

Raab v. General Physics Corporation, 4 F.3d 286 (4th Cir. 1993) 4

Time-Warner Inc. Sec. Litig., In re, 9 F.3d 259 (2d Cir. 1993) 6

VeriFone Sec. Litig., In re, 11 F.3d 865 (9th Cir. 1993) 6

Statutes and Rules

Fed. R. Civ. P. 9(b) ..... *passim*

Private Securities Litigation Reform Act of 1995, Public Law 104-67 (to be codified at 15 U.S.C. § 77) 1

Supreme Court Rule 15.6 1

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

Respondents The Price Company, Robert E. Price, Dennis R. Zook and Theodore Wallace, under Supreme Court Rule 15.6, hereby submit this reply brief addressing arguments raised by respondents in their brief in opposition to petition for a writ of certiorari.

I. The Important Question Presented by This Petition Has Not Been Decided with Respect to Hundreds of Cases Pending in the Federal Courts, and This Court Should Adopt a Uniform and Rigorous Rule 9(b) Standard for These Cases.

Respondents overlook the fundamental fact that this case – and the hundreds of other federal securities fraud actions which were pending in the federal court system as of December 21, 1995 – remain subject to conflicting and divergent interpretations of Rule 9(b) by various circuit courts of appeal, notwithstanding Congress' recent enactment of the Private Securities Litigation Reform Act of 1995 ("the Act"). In particular, the Ninth Circuit Court of Appeals has adopted an anomalous Rule 9(b) pleading standard, which does not evaluate whether pleaded allegations are sufficient to raise an inference of fraudulent intent, but merely inquires whether the pleading alleges some explanation why the challenged statements were false or misleading when made.[1]

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[1] *Compare In re GlenFed Sec. Litig.*, 42 F.3d 1541, 1548-1549 (9th Cir. 1994) *(en banc) with, e.g., O'Brien v. National Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991); *Greenstone v. Cambex Corp.*, 975 F.2d 22, 25-27 (1st Cir. 1992) (Breyer, J.); *DiLeo*

Because such conflicting interpretations of Rule 9(b) persist notwithstanding passage of the Act, it is just and appropriate that this Court establish a uniform Rule 9(b) pleading standard governing all federal securities fraud actions predating the Act. Petitioners respectfully submit that the most cogent interpretation of Rule 9(b) is the one which requires securities fraud plaintiffs to plead sufficient facts to raise a strong inference of fraudulent intent – the very interpretation rejected by the Ninth Circuit but later enacted into law by Congress.

II. This Court Should Grant the Writ and Expressly Reject Respondents' Position that Allegations of Isolated Employee Stock Sales Are Sufficient to Raise an Inference of Fraudulent Intent Under Rule 9(b).

The district judge in this case ruled that plaintiffs' allegations were insufficient to satisfy Rule 9(b). App. 131, 133. The Ninth Circuit Court of Appeals, however, reversed the district court's judgment of dismissal, applying the Ninth Circuit's own unique and recently fashioned "explanation of falsity" Rule 9(b) standard. Remarkably, respondents in their brief in opposition do not attempt to defend the Ninth Circuit's aberrant Rule 9(b) pleading standard. Rather, respondents assert that the allegations made in this case would satisfy even a "strong inference of fraudulent intent" Rule 9(b) standard. *See* Brief in opposition 6-10.

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v. Ernst & Young, 901 F.2d 624, 630 (7th Cir. 1990), *cert. denied*, 498 U.S. 941 (1990).

In particular, respondents argue that their allegations of stock sales by two company officers suffice to raise an inference of fraudulent intent satisfying Rule 9(b) – thereby authorizing respondents to proceed through the expensive, time-consuming and disruptive pretrial discovery process. This proposition merits critical review by this Court under *any* reasonable interpretation of Rule 9(b).

Respondents' underlying allegations in this case were constructed around two basic *non sequiturs:*

1. An earnings decline was publicly reported on April 2, 1992; therefore, The Price Company defendants must have conspired to suppress negative information about the company's economic condition before them.

2. Two individual officers of The Price Company sold some Price Company Stock in periods before the announced earnings decline; therefore, they must have taken steps to inflate the stock price before they made their sales and must have known the stock price would later decline.

Petitioners respectfully submit that such hindsight speculation fails to state a legally sufficient claim under Rule 9(b) and the federal securities laws.

The phrase "fraud by hindsight" was coined by Judge Henry Friendly in *Denny v. Barber,* 576 F.2d 465 (2d Cir. 1978). In that case, the Court observed that "plaintiff has simply seized upon disclosures made in later . . . reports and alleged that they should have been made in earlier ones" and dismissed the action on the ground that deficient powers of clairvoyance do not constitute

actionable fraud. *Id.* at 470.[2] Judge Friendly's sage remarks about "fraud by hindsight" have been cited and applied in numerous recent decisions adopting a stringent interpretation of Rule 9(b), and are particularly pertinent in this case.[3]

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[2] The Seventh Circuit aptly has framed the "fraud by hindsight" issue in the following terms:

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud.

DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990) (affirming dismissal), *cert. denied*, 498 U.S. 941 (1990).

[3] *See, e.g., Greenstone v. Cambex Corp.*, 975 F.2d 22, 25-27 (1st Cir. 1992) ("To permit a securities fraud complaint to state, without more, that the corporation's executives 'knew' in 1991 about the likely decline in 1992 sales would sanction what Judge Friendly called 'fraud by hindsight,' [citation omitted], a practice that courts have not allowed") (Breyer, J.); *Raab v. General Physics Corporation*, 4 F.3d 286, 291 (4th Cir. 1993) ("[P]redictions about earnings for the latter three quarters of 1992 proved incorrect, but hindsight does not establish fraud") (affirming dismissal with prejudice); *Arazie v. Mullane*, 2 F.3d 1456, 1467-1468 (7th Cir. 1993) ("[T]emporal proximity between positive statements stressing a firm's strengths and announcements of poor economic performance do not create an inference that the earlier statements were fraudulent") (affirming dismissal without leave to amend).

First, the retailing industry in which The Price Company operates is among the most competitive in the world. What may appear to be a prudent course to follow early in one quarter may appear to management not to be working successfully when an economic downturn occurs or after management has the benefit of another quarter's experience. Indeed, companies in the retailing business (as well as other rapidly changing industries) are especially vulnerable to suits based on the temporal proximity of hopeful expectations and disappointing results. Corporate officers should not be burdened by the risk that if they tailor corporate strategies to evolving marketplace conditions, their lack of inertia will be viewed as evidence that they were lying in the first place. But the Ninth Circuit's opinion in this case aggravates and actualizes this unfair risk. The Ninth Circuit's opinion holds that a company's announcement of a change in business strategy, made within a few months of the company's optimistic statements about the prior strategy, amounts to "circumstantial evidence" of fraud. App. 12-13.

Second, the Ninth Circuit opinion in this case also holds – and respondents now argue to this Court – that stock sales by two Price Company officers in periods before the April 2, 1992 earnings release constitute circumstantial evidence of fraud. App. 13-14; brief in opposition 6-10. Respondents go so far as to assert – again from the perspective of hindsight – that these alleged insider stock sales suffice to create a "strong inference of *scienter*" under Rule 9(b). Brief in opposition 8. This assertion must be rejected as a matter of both law and logic.

In companies regularly targeted by shareholder suits, incentive stock options typically are a major part of the

overall executive compensation package. As a result, it is to be expected that in any given quarter of the fiscal year, some executives will sell some of their option stock. Whereas "[i]nsider trading in suspicious amounts or at suspicious times" may be probative of motive or intent in a securities fraud action, *see In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990), this Court should disavow the illogical and unfair notion that allegations of isolated employee stock sales are themselves sufficient to create a strong inference of fraudulent intent which satisfies threshold Rule 9(b) pleading requirements.[4] The Ninth Circuit Court of Appeals itself recognized the correct rule of law in *In re VeriFone Sec. Litig.*, 11 F.3d 865, 872 (9th Cir. 1993), holding that absent legally sufficient allegations identifying an underlying violation of the antifraud provisions of the securities laws, allegations of insider stock sales cannot save a complaint from dismissal.[5]

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[4] Significantly, none of the Second Circuit decisions cited by respondents, fairly read, supports the proposition that allegations of employee stock sales are sufficient to satisfy Rule 9(b) absent substantial other evidence of fraud. *See Goldman v. Belden*, 754 F.2d 1059, 1069-1070 (2d Cir. 1985) (citing numerous detailed allegations concerning circumstances of alleged fraud besides alleged employee stock sales); *Cosmas v. Hassett*, 886 F.2d 8, 11-13 (2d Cir. 1989) (same); *In re Time-Warner Inc. Sec. Litig.*, 9 F.3d 259, 264-271 (2d Cir. 1993) (same); *Cohen v. Koenig*, 25 F.3d 1168, 1173-1174 (2d Cir. 1994) (same).

[5] In *VeriFone*, the Ninth Circuit affirmed a dismissal with prejudice of a shareholder suit notwithstanding allegations that "in excess of 719,900 shares out of the 3.9 million shares of VeriFone common stock" had been sold by company officers and directors during the period of the claimed fraud. *Id.* at 871.

Petitioners respectfully submit that this Court should grant the writ and should affirm that "fraud by hindsight" allegations based upon disappointing quarterly earnings and isolated employee stock sales – which were deemed sufficient in this case by the Ninth Circuit Court of Appeals – do not satisfy the special pleading requirements of Rule 9(b).

CONCLUSION

For all the foregoing reasons, as well as the reasons set forth in their petition, petitioners The Price Company, Robert E. Price, Dennis R. Zook and Theodore Wallace respectfully request that this Court grant a Writ of Certiorari to review the decision of the Ninth Circuit Court of Appeals, which reversed the district court's judgment of dismissal in this case.

Respectfully submitted,

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